

VZCZCXYZ0001  
PP RUEHWEB

DE RUEHKV #2434/01 3461541  
ZNY CCCCC ZZH  
P 111541Z DEC 08  
FM AMEMBASSY KYIV  
TO RUEHC/SECSTATE WASHDC PRIORITY 6910  
INFO RUCNCIS/CIS COLLECTIVE PRIORITY  
RUEHZG/NATO EU COLLECTIVE PRIORITY  
RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY  
RUCPDOG/DEPT OF COMMERCE WASHINGTON DC PRIORITY  
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC PRIORITY

C O N F I D E N T I A L KYIV 002434

SIPDIS

DEPT FOR EUR, EUR/UMB, EEB/OMA  
TREASURY PASS TO TTORGERSON

E.O. 12958: DECL: 12/11/2018  
TAGS: [EFIN](#) [EREL](#) [ETRD](#) [PGOV](#) [PREL](#) [XH](#) [UP](#)  
SUBJECT: UNSTEADY UKRAINE RESPONSE WORRIES IMF TEAM

REF: A. KYIV 2412  
[1](#)B. KYIV 2413  
[1](#)C. KYIV 2207

Classified By: ECONOMIC COUNSELOR EDWARD KASKA, REASONS 1.4(B) AND (D)

[1](#)1. (C) Summary. An IMF team led by Ceyla Pazarbasioglu, in Kyiv to assess Ukrainian implementation of the Fund's \$16.4 billion Stand-By Arrangement (SBA), offered mixed reviews of GOU anti-crisis efforts during her December 10 meeting with the Ambassador. Pazarbasioglu complimented Minister of Finance Viktor Pynzenyk and National Bank of Ukraine (NBU) Governor Stelmakh for "trying to do the right thing" but lamented political weakness and conflicts of interest in their respective institutions. Her insights on Ukraine's 2009 budget, bank recapitalization program, and external financing gap were mostly dour, as was her assessment of the potential for GOU bungling of Prominvestbank's nationalization. Pazarbasioglu called for greater EU engagement in the eastern European financial crisis, perhaps through a Brady Bond-type solution to the region's debt and liquidity problems. She asked for the U.S. government to weigh in with EU counterparts on the Brady Bond idea, as well as consider providing a qualified banking advisor to serve as an impartial member of the Prominvestbank board. End summary.

IMF Back in Ukraine  
-----

[1](#)2. (SBU) Pazarbasioglu and her crew of policy and technical advisors traveled to Kyiv on December 1-11 for an interim look at Ukraine's adherence to the SBA's conditionalities. Pazarbasioglu arrived just over a month after the SBA was finalized, seeking to contain apparent problems with GOU coordination and program implementation. During her stay, Pazarbasioglu met with senior government officials, private businessmen (including those she called "billionaires"), and a group of foreign ambassadors. She requested a separate private conversation on December 10 with the U.S. Ambassador to provide a candid readout of her trip and request U.S. backing for IMF supported programs.

Unsteady Hands at Finance, NBU  
-----

[1](#)3. (C) Assessing two of Ukraine's primary decision makers in the financial crisis, Pazarbasioglu mixed praise with stinging criticisms, repeated often to us by senior IMF officials. On the Minister of Finance: Pynzenyk "cares and is trying to do the right thing," said Pazarbasioglu. "I don't think he has the Prime Minister's backing, but I hope he stays." Pazarbasioglu's erstwhile lieutenant (see comment in paragraph 11), resident IMF representative Balazs Horvath,

observed that Pynzenyk lacks political clout. Isolated from PM Yulia Tymoshenko, he operates as if a "Damocles sword is hanging over him." On the NBU Governor, Pazarbasioglu and Horvath both spoke of their admiration for Stelmakh's personal integrity. In general, "Pynzenyk and Stelmakh talk to each other," said Horvath, though there is a lack of policy coordination between the Minister of Finance and the NBU Governor, reflected at all levels. The IMF has taken the unusual role of "hand holding" between the two institutions in an effort to coordinate strategy and create safeguards for the SBA.

14. (C) Pazarbasioglu said the top NBU management "doesn't understand or have expertise to deal with a flexible exchange rate." "This is doubly difficult," she said, "when the banking system is fragile and there is an environment of political uncertainty." The NBU's clumsy management of the hryvnia depreciation in November caused reserves to fall by over \$2 billion. Pazarbasioglu said that the IMF was forced to demand a halt on NBU interventions after the NBU repeatedly sold dollars in a non-transparent manner, often below market rates. Only after the IMF provided a technical advisor to the NBU did the central bank begin to conduct more transparent currency auctions that priced foreign exchange near the market rate. Pazarbasioglu expects the hryvnia to stabilize in the short term. She did say, however, that the hryvnia could depreciate further due to the inflation differential to the dollar, perhaps to a rate of "8 UAH/\$1 or even 10 UAH/\$1."

15. (C) As an institution, the NBU has a "Soviet mentality" toward its core economic functions, and it thinks "very differently" from other central banks. Pazarbasioglu recalled an example of the NBU's explanation of its monetary policy controls. Stelmakh equated any potential interest rate increase with higher rates of inflation, even as Ukraine struggles with falling GDP and a large current account deficit. Pazarbasioglu and Horvath reiterated accusations of conflicts of interest at the NBU's council, where business and political influences seep into the central bank's policy making. NBU council head Petro Poroshenko was singled out as a particular epitome of the council's deleterious role.

#### Financing Gap

16. (SBU) Pazarbasioglu confirmed that a supposed \$27 billion financing gap, cited in PM Tymoshenko's November 4 letter to Treasury Secretary Paulson and again during the Ambassador's December 4 conversation with Minister Pynzenyk (Ref A), is not an IMF projection. The IMF has not changed its projection of the financing gap for 2008-2010, which remains at roughly \$16.4 billion for 2008-2010, and is meant to be covered by the SBA. Pazarbasioglu emphasized, however, that the IMF program made certain assumptions, particularly that i) the GOU would implement SBA conditionalities, ii) most bank debt due in 2009 would be rolled over, and iii) the world economy would rebound in the second half of 2009. Although she had not seen the \$27 billion projection cited by the GOU, she understood how the GOU arrived at the figure. If less bank debt were rolled over, if outstanding sovereign debt faced cross-triggers, or if the IMF's assumptions about the global economy did not hold, then the financing gap could be much larger than what the IMF has projected.

#### Ukraine's 2009 Budget

17. (SBU) Having previewed the Ministry of Finance's draft 2009 budget in tandem with the World Bank (Ref B), the IMF agrees with the World Bank's assessment that the budget is not yet close to being balanced. The biggest culprits are a huge drop in revenues, combined with a large deficit in the pension fund, according to the IMF. Pazarbasioglu expressed satisfaction that the Ministry had based its austere fiscal policy on conservative revenue assumptions. However, even as the draft plan would cut public wages and eliminate nearly all capital spending, pensions would continue to push the

government's overall costs. The IMF has recommended serious pension reform to the GOU, as Ukraine faces a rare convergence of short and long-term adjustment needs. (Note: The SBA conditionality of a 2009 balanced budget is driving immediate cutting measures, while projections of the country's rapidly aging population may force the GOU to take a broader approach to a reform package. End note.)

#### Banking Diagnostics

-----

18. (SBU) The IMF gave a "thumbs-up" to the ongoing diagnostic audits of Ukraine's 17 largest banks. The audit process is due to finish by December 15, when examiners will present their initial findings to the GOU and IMF. Originally, the IMF had asked external auditors to investigate 30 percent of the banks' loans. Because the sector has recently experienced deteriorating loan performance, however, the IMF team revised its request and is now asking auditors to include reports on 50 percent of all bank loans. Pazarbasioglu expects the auditors to file for extensions and submit final reports around the end of the year.

#### USG Assistance Request

-----

19. (SBU) Pazarbasioglu considered Prominvestbank's impending nationalization to be a mixed blessing. A high-profile casualty of Ukraine's recent financial crisis, Prominvestbank could serve as a "critical precedent" for future GOU interventions in Ukraine's wobbly banking sector. On the other hand, the IMF estimates that there is currently little NBU capacity to administer problem pwQ MQZBn the boards of Ukraine's failed banks, with Prominvestbank serving as a significant test case. According to Pazarbasioglu, this effort to add impartiality and bridge the roles of the Ministry of Finance and the NBU has been endorsed by Minister

of Finance Pynzenyk and Deputy Prime Minister Nemyria. (Note: The GOU announced plans on December 10 to take over Prominvestbank -- the sixth largest bank in Ukraine and subject of much rumor and speculation in the country's financial circles (Ref C) -- after a bid by the Klyuyev brothers collapsed due to a lack of external financing. End note.) The IMF had been concerned that "strategic investors" secured their bid through political connections in parliament and close ties to the NBU's council, and Pazarbasioglu stressed the need to prevent a similar event from happening in the future.

110. (SBU) Pazarbasioglu also asked that the USG weigh in with EU counterparts to encourage them to implement a solution to the financial crisis that has spread throughout eastern Europe. She suggested the model of U.S. Brady Bonds that helped Latin American countries restructure debt in the late 1980s and early 1990s. The IMF said that Europe should play a special role in the region, because its banks had pushed expansions of capital lending and reaped huge profits as a result. (Note: Embassy Kyiv conveyed these requests to Treasury on December 10. End note.)

#### Comment

-----

111. (C) Pazarbasioglu and Horvath were aligned in their thinking on every topic discussed, despite apparent personal tensions between them. Horvath took the opportunity of Pazarbasioglu's late arrival to inform the Ambassador of his immediate departure from Kyiv. He said his exodus from IMF had been in the works for some time, due to an internal IMF dispute earlier in 2008 over the planned closure of the Ukraine mission (to which he had been opposed). For her part, Pazarbasioglu expressed no regret that Horvath was leaving, even though Post has considered him a valuable contact and first-rate analyst of Ukraine's economic problems. There are plans to replace Horvath, but Pazarbasioglu speculated that a new resident IMF

representative would not arrive until late January 2009.

¶12. (C) Pazarbasioglu and Horvath's impressions of NBU Governor Stelmakh and Minister of Finance Pynzenyk were notably more charitable than their general appraisal of the GOU's crisis response. That they separated the Minister and the Governor from their institutions sheds light on the fact that the IMF views each man as lacking control or power more broadly in the government.  
PETTIT